1812

THE NATIONAL CITY BANK OF NEW YORK

1950

Monthly Letter on
Economic Conditions
Government Finance

New York, January, 1950

General Business Conditions

THE closing weeks of 1949 have brought good reports from trade and the industries. Merchants hoped for a big Christmas business, and have seen their hopes realized. In the four weeks ended December 24th department store sales over the country were equal to last year, in dollars. Prices are lower than a year ago, probably by 5 or 6 per cent on the average. Thus unit sales have been larger, and Christmas merchandise has been well cleaned up.

The industries as a whole are working at the best rate since last Spring. Order books are well filled in textiles, household equipment and a good many other lines, which are assured of high-level operations for some months. The steel strike reduced steel inventories, and the catching-up period evidently will extend into next Spring. Coal stockpiles need replenishing and the country ought to have more coal than Mr. Lewis at present is allowing to be mined. Automobile companies are scheduling a higher output in the early months of 1950 than in 1949. Construction contract awards have continued unseasonally high; in the first three weeks of December they were 39 per cent above a year ago.

With reports of this kind coming in, most year-end reviews are cheerful, and the general forecast for at least the early months of 1950 is one of confidence. The state of the industries indicates that their output in the aggregate will rise further during the Winter, which signifies higher industrial employment and payrolls and good trade. This month the Treasury will start paying out \$2.8 billion of insurance premium refunds to veterans. Doubtless these payments have been anticipated to some extent by purchases on credit, but experience with bonuses and similar disbursements in the past has shown that they stimulate retail buying sharply.

The Record of 1949

Business activity has stayed higher during 1949, and the year has closed with business in a more promising position than was generally thought possible in the pessimistic days of last Spring. In industrial output 1949 has averaged about 175 (1935-39 = 100), according to the Federal Reserve Board's index, 9 per cent below 1948. At the July bottom it was 17 per cent below the November 1948 top. In numbers of people at work, and in the money incomes they have enjoyed, the drop has been insignificant. Using monthly estimates made by the Bureau of the Census, employment in the first eleven months of 1949 averaged only 1 per cent below the 1948 level. Personal incomes and consumer expenditures during the year were substantially equal to 1948, and the value of the country's output of goods and services (gross national product) dropped only 1 per cent, although wholesale commodity prices have averaged 6 per cent lower. U. S. exports for the first 10 months declined 3½ per cent. The value of farm production for the year was 10 per cent lower, reflecting a decline of 12 per cent in average prices received, as compared with 1948.

CONTENTS

Business expenditures for plant and equipment dropped 7 per cent, according to surveys made by the Securities and Exchange Commission and the Department of Commerce. Total construction expenditures increased 2 per cent.

Inspection of these figures shows that the Spring recession was predominantly in industrial operations, and not in the consumption of goods and services. It is now plain that the decline reflected mostly a sharp curtailment of business buying, reduction of inventories, and shortening of commitments. The Department of Commerce collects inventory figures, which show that manufacturers' stocks dropped $3.8 billion, or 11 per cent, from January through October 1949. In short, more goods were consumed than were produced. The drop in buying and the industrial curtailment, which seemed so depressing last Spring, were in fact laying the ground for the recovery that has since occurred.

Fears of Renewed Inflation

It is not surprising, in view of the turn in recent months, that fears of a resurgence of inflationary price advances are being expressed in some quarters. The argument is that the postwar inflation has only been interrupted, not halted; that accumulated needs still exist in many lines and people have money to satisfy them; and that demands will again approach the limits of supply and capacity to produce, setting the stage for another upward spiral. Many fourth round wage increases, generally taking the form of pensions and other allowances, have been granted. Doubtless more will come. Industrial costs are raised accordingly. The price of steel has been advanced and non-ferrous metals markets are stronger. Some shortages of merchandise and materials have been reported.

People have immense purchasing power, backed by holdings of cash or liquid assets, and the Christmas trade figures show a readiness to use it. Most well-established businesses are in good financial condition. The banking system is strong and liquid and able to take care of creditworthy borrowers as they come forward. Money rates are low and the easy money policy of the Treasury and Federal Reserve System persists. Finally, the Federal Government is spending more than it takes in, and state and local governments are also borrowing for highways, institutional building, and other purposes.

However, a belief that these influences will start an upward price spiral again, in any considerable degree, seems incompatible with other elements in the outlook. Buying scrambles, inventory build-ups and speculative excesses thrive on shortages. The country now has a greater cushion of industrial and transport capacity, food and material supplies, and labor resources than in 1947 and 1948. The pipelines through which goods are distributed are far better filled and many urgent demands have been satisfied. Moreover, exports have shrunk and some capital goods industries are slackening, which reduces demand.

Nor is it likely that business men will give much weight, in their day-to-day decisions, to fear of resurgent inflation. There is little evidence that they are inclined to take speculative positions or to depart from the conservatism which has served many of them well. Merchants' commitments, as indicated by department store surveys, are being kept well in hand; in fact, it is a common observation that business in finished textiles and apparel has not shown the sharp rise that has occurred in the primary cloth markets. Surveys such as that of the National Association of Purchasing Agents show that industrial buyers generally are limiting their commitments to short terms. In last analysis, the behavior of buyers will dominate the situation.

Belief that renewed inflation is on the way is also incompatible with the evidence that some of the dynamic influences which were active in 1947 and 1948 have weakened. Not all segments of the economy are going forward strongly together. Exports, farm buying power, and business expenditures for plant and equipment are expected to be lower in 1950 than in the earlier inflationary years. All contribute heavily to total demand. The increase in the money supply resulting from federal deficit financing is an inflationary force; here much depends upon what Congress does with respect to expenditures.

The Export Outlook

United States merchandise exports have been in a declining trend since the second quarter of 1947. At that time they reached the unprecedented rate of $15.7 billion annually. During the three months ending last October, the rate was down by one-third to $10.5 billion. The export surplus also has contracted, from the peak rate of about $10 billion annually to a current rate of $4.2 billion. The current surplus of merchandise exports is actually somewhat smaller than our current foreign aid expenditures.

Since the existence of any surplus at all is largely dependent upon foreign grants and aids, it will decline more if grants and aids are reduced, as seems likely. To be sure, the contraction to be expected in 1950 seems moderate. Cuts in foreign aid appropriations will not exert much effect on actual shipments until the second

half year. Foreigners will earn more dollars through U. S. tourist expenditures and from their shipping services in 1950 than in 1949. Their gold production has been encouraged by currency devaluations, which also make it possible for them to sell goods here at lower prices. With high industrial activity in this country, their earnings from exports to the United States should show little or no decline. Including grants and aids, private remittances, American investments and credits extended by private lenders and the international institutions, the supply of dollars available for the purchase of American goods will contract little if any.

But the foreign countries which acquire these dollars may not spend them as avidly as in the recent past. They are catching up with some of their needs, and in particular require less food from us. They are on notice that our aid will decline and they want to build up reserves to strengthen their position against the ending of the Marshall program in 1952. Since the currency devaluations last September they have been drawing gold from us and building up dollar balances. Thus some reduction in our export surplus is to be expected, at least in the second half year.

Farm Buying Power Weakening

It is also to be expected that farmers will be buying fewer industrial goods, as 1950 goes on, than in other recent years. In many farm products stocks are accumulating, and production needs to be cut back. The Government, while supporting prices at or close to 1949 levels, is enforcing acreage restriction in wheat and cotton and will do so in corn. In other commodities whose production is unrestricted, support prices in many cases will be lower. Thus the trend is toward a drop in income either through lower prices or smaller output. There are, to be sure, many variables in the outlook. If the weather is good and production of the crops supported by the Commodity Credit Corporation is large even on the lower acreage, the income prospect will improve — at the expense of the C.C.C. Production of animal products will increase, and help hold up the gross return even at lower prices. Altogether, however, government and private agencies now predict a drop of some 10 per cent in farm cash income in 1950, which would bring the total to around $25 billion, compared with $27.5 in 1949 and the peak of $30.8 billion in 1948.

In November, for the first time since late 1941, the ratio of prices which farmers receive to prices of things they buy dropped back to the calculated "parity", which with certain exceptions means the relationship between these prices (as measured by Dept. of Agriculture indexes) that existed from 1909 through 1914. Stating parity as 100, the ratio reached a peak of 133 in the Fall of 1946. The drop to 100 marks the end of eight years of abnormally high farm prices, and by present prospects the figure will fall below 100 and remain below it during much of 1950.

Appraisals of the effects of the drop in farm income should take account of the strong financial position of the farmers, who hold liquid assets far greater than their total debt, and of the purchasing power which they enjoy in consequence. Moreover, the drop in income, to the extent that it results from lower prices, has an offset in the savings which city people will make in the cost of their food. They will have more with which to buy other goods and services. On the other hand, retrenchment in farm expenditures tends to cause a decline in city incomes. At any rate, it seems safe to assume that the farm situation will not be an inflationary influence on total demand in 1950, but rather the contrary.

Capital Expenditures Declining

Another of the dynamic forces which created the boom and which has now weakened is business spending for plant and equipment. We noted earlier a drop of 7 per cent in these expenditures in 1949. The common opinion is that a further drop will occur during 1950. The S.E.C.-Commerce Department survey indicates that the total in the first quarter of the year will be 13 per cent below the first quarter of 1949. Other preliminary reports agree fairly well with these estimates. Of course surveys cover only intentions, which may change as the business situation develops. The inducement to install labor saving machinery is strong and funds are available through depreciation allowances, retained earnings, investment markets open to well-established borrowers, and a liquid banking position. However, a considerable decline in railway capital expenditures is expected and many of the huge postwar projects planned by the industries are completed, with nothing of equal size to take their place. In the general industrial field construction is falling off.

Capital expenditures play an immensely influential part in business swings. They fluctuate more widely and over a longer cycle than the industries making staple consumer goods. When they are strong and active the influence of their purchases of materials and supplies, the employment they give and the income they generate, extends far into other industries. When they are

slack the demand for consumers' goods feels the drag. Fears of a resurgence of inflation at a time when capital expenditures are declining are incongruous. The fact is that any severe drop in plant and equipment buying would be viewed by almost everyone with apprehension.

In summary, examination of the prospect for capital expenditures, farm income and exports suggests that the question of chief concern is not whether inflation is to revive, but whether some softening of the business situation in the second half year should be anticipated. If these influential components of total demand drag, it would be remarkable if many of the lighter industries whose recovery began last Summer should continue to rise through next Summer. Fortunately the drop in all these areas promises to be moderate. The country in 1947 and 1948 was trying to do too much in too short a time, with inflationary effects not too pleasant to remember, and 1949 has shown that it can stand subsidence of demand without collapse or depression. The supporting factors are still strong.

New Wage Demands

The American Federation of Labor announced on December 26 that its unions will seek substantial wage increases next year on grounds which ought to be noted. The essence of its position is that business will go into a slump after next June unless consumer buying power is strengthened by higher wages and lower prices. It said that if every worker in the United States received a 10c an hour wage increase "it would be enough to reverse the prospective downward trend and start a rise". Thus it said wage increases in 1950 must be "substantial" and "large."

This is the so-called "purchasing power theory," proclaimed over and over by labor leaders in this and other countries and by their economic consultants and advisers, and also by men influential in government. The doctrine, in the words of Prof. Sumner H. Slichter of Harvard, is that "the way to halt a drop in the demand for labor is to raise the price of labor." Prof. Slichter has ably exposed the fallacies of this doctrine in the November issue of The Review of Economics and Statistics, published by Harvard University. He points out that in some plants the immediate effects of higher wage rates, if not passed along in prices, would be a reduction in employment and payrolls. In this case the theory obviously defeats itself. He goes on to consider other cases, as follows:

> Raising wages in plants where wage increases will raise payrolls is not likely to be effective in halting a contraction of business. In the first place, the immediate effect of higher wages is to produce some shrinkage of employment in the plants where payrolls increase. In the second place, the increase in payrolls at a time when demand is shrinking and prices are too high to equate supply and demand is more likely to produce deflationary effects (further reduction of inventories, smaller demand for raw materials, postponement of expenditures on plant and equipment, accelerated repayment of debts, reduction of dividend payments) than inflationary effects (reduction in hoarding, greater use of outside funds, liquidation of securities). Indeed, raising the price of labor in a contracting market appears to be a good way of aggravating the contraction.

Moreover, Prof. Slichter adds, the wage raising policy would not only "fail to halt contraction, but it would limit the effectiveness of other policies which would mitigate the contraction, namely lower prices" . . . The way to induce consumers to buy more "is to offer them more attractive goods at more attractive prices. Wage increases would interfere with this process because they would limit both the ability and willingness of enterprises to cut prices."

The lesson of 1949 is that what is to be feared in 1950, as the originating cause of business softening, is not a decline in consumer spending but a drop in business spending. When business spending is slow, consumer income suffers. An economy in which expenditures on producers' plant and equipment are sluggish is a stagnant economy. All economic progress depends upon more and better facilities for producing and distributing more and better goods and services. The A.F. of L. recognizes this truth, and urges business to spend for this purpose, in every economic program it lays down. But Prof. Slichter shows that its program of trying to offset a decline in business spending by raising wages would aggravate the decline. The real need is to maintain business confidence and business incentives.

Why the Dearth of Risk Capital?

What has happened to risk capital? Once again this question crops up, this time as the subject of investigation by a House-Senate Economic subcommittee headed by Senator O'Mahoney, of Wyoming, which began hearings last month.

"The private capitalistic system is being threatened by a lack of venture capital, and it cannot exist unless there is a steady flow of private capital into the economy in terms of ownership as well as in terms of debt," declared Mr. O'Mahoney at the outset of the investigation. "The testimony of experienced men in the investment markets," he continued, "seems to indicate that the majority of people with savings are more desirous of security for those savings than they are for large profits from new ventures, or even

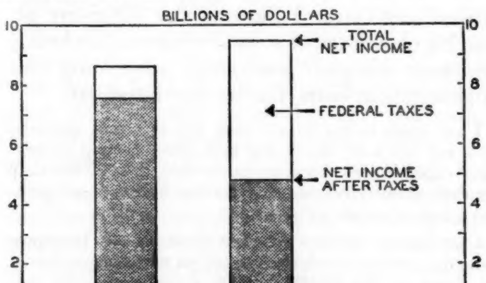
from old ventures. They are therefore investing most of their savings in government bonds, in life insurance policies, and in savings banks."

The committee will be doing a great service if it brings out the real facts as to causes of these conditions and drives them home to the American people. The surprising thing, however, is that there is still doubt in anyone's mind as to why the stream of venture capital has not been flowing into enterprise with its old-time vigor and daring. The reasons, indeed, are plain, and have been emphasized again and again by business men, investors, economists, and others.

The Terrific Toll of Taxes

The first and most important reason – which requires no economic wizard to discover – is the steeply graduated federal income and estate taxes, which (along with the myriad of other taxes) exact a terrific toll from the fortunes of the relatively well-to-do from which the savings for risk investments have been so largely drawn, particularly for new and untried business ventures.

To illustrate how graduated taxes – ranging up to 82 per cent in the case of the federal income tax, and to 77 per cent in the federal estate tax – have drained off this pool of upper incomes, let us take, for example, the figures for incomes in excess of $25,000. The following diagram compares the estimates given in the Senate Finance Committee report on the Revenue Act of 1948, giving effect to the tax cut, with the Treasury Department report on Statistics of Income for 1928 – twenty years before, when the tax burden was still moderate.



Total of Individual Incomes over $25,000, Federal Taxes, and Net Income after Taxes. Based on 111,232 Returns in 1928 and an Estimated 174,200 in 1948.

It will be seen that the total pool of net incomes above the $25,000 bracket increased from $8,636 million in 1928 to an estimated $9,472 million in 1948, or by 10 per cent. This in itself is an amazingly small gain considering the tremendous expansion of the total national income, brought about by the war and its attendant inflation, from $79 billion to $226 billion. Here we see one effect of the cumulative erosion of taxes upon the upper incomes.

But it is in the income left after taxes that the killing effect of taxes shows up most strikingly. While the pre-tax income of this high income group managed to record a modest increase between 1928 and 1948, their federal income taxes soared from $1,045 million to $4,660 million, or by more than four-fold. In consequence, the balance of net income after tax fell heavily, from $7,590 million to $4,812 million – a drop of 36 per cent.

Less Income to Do More Work

Moreover, this decline in net income after taxes of this group occurred in spite of the general upshifting of incomes resulting from inflation, including the moving of more taxpayers over the $25,000 level. As shown by the following table, the number of persons reporting incomes in excess of $25,000 increased from 111,000 in 1928 to an estimated 174,000 in 1948.

This means that a pool of income that was much smaller had to support far more people. In other words, the average income of such individual taxpayers after the U. S. Treasury had taken its slice was cut from $68,000 to $28,000.

Federal Individual Income Tax Returns Over $25,000

	1928	1948 Est.
Number of returns	111,232	174,200
Income subject to tax	$8,635,588,000	$9,472,300,000
Federal tax	1,045,198,000	4,660,300,000
Net income after tax	7,590,390,000	4,812,000,000
Average income after tax per return:		
As currently reported	68,239	27,623
Adjusted for change in purchasing power of the dollar	68,239	19,787
Total national income	$78,700,000,000	$226,204,000,000

Sources: Treasury Department report on Statistics of Income for 1928; Senate Finance Committee report on Revenue Act of 1948.

Still this does not allow for the change in the purchasing power of these dollars. Adjusting by the Department of Commerce consumers price index indicates that the average taxpayer in the over $25,000 class had in 1948, after he had paid his federal income tax, a disposable income worth not $28,000 but, in terms of 1928 dollars, only $20,000.

Squeezed thus by both rising taxes and living costs, the average "wealthy" taxpayer finds his margin for saving correspondingly reduced, and in many cases wiped out, with many high bracket taxpayers compelled to invade capital.

Then when this shrunken total of savings available for risk enterprise tries to go to work, what does it find? Because of the rise of prices, it takes twice as much money to start a new busi-

ness or expand an old one. This holds true as to the value of inventory that will have to be carried, the investment in tools and equipment, and the costs generally.

"Heads You Win, Tails I Lose"

Today we see the shares of many well-known companies with long dividend records selling on the stock exchanges at prices yielding 6, 7, and even 10 per cent to the purchaser. Certainly these yields look attractive. Yet for the average small investor unfamiliarity with stock investing constitutes a strong deterrent. Many got badly "burned" in the stock market collapse of 1929. At the same time for the investor in the upper income brackets these 6, 7, and 10 per cent yields are, thanks to the tax collector, much more apparent than real. In the case of an investor, for example, who reaches the 50 per cent tax bracket, which will be at a net income of $44,000 for a husband and wife, the current return after tax is cut to 3, 3½, and 5 per cent, with all the risks attendant upon an ownership position. If the investment pans out successfully and yields a profit through capital appreciation, the Government takes a minimum of 25 per cent of the gain. On the other hand, if the stock goes sour and the investor "loses his shirt," he stands the loss himself, except for the $1,000 which he is permitted to deduct from other income in computing his overall tax.

In other words, for the large investor at least, it is a good deal like "heads you win, tails I lose." Barring the prospect of pretty sure appreciation, the game seems to many hardly worth the candle.

Because of the unreceptive market for new stock issues, many companies have found it too difficult and costly to raise equity capital from outside investors, and have either had to borrow or cut back expansion plans accordingly. When this is true of large corporations whose names are known in every household, how much more is it true of the "little fellow" who is trying to start a new business or build a little business into a bigger one. It is fortunate for the country that so many concerns have been able to finance their requirements largely from their good earnings since the war. Yet these earnings have been subject to constant criticism as being excessive. Even as it is, good earnings for established enterprises do not provide the answer to the problem of finding the equity capital for starting new businesses. This dependence on earnings for equity capital weights the scales in favor of large going concerns.

The ramifications of this whole question are widespread. We are told, for example, that we must invest more abroad, to help alleviate the dollar shortage and develop the resources of economically backward countries. Yet if American investors are not attracted by the high yields on seasoned securities at home, why should they want to expose their savings to unknown risks in foreign lands?

Spending and Taxing Too Much

What all this really comes down to is that we are spending and taxing too much. Here we see the seamy side of programs that call for the spending of billions of dollars in subsidies, bonuses, and ambitious social welfare schemes at a time when the budget is already overburdened by the enormous load of the cold war.

It is all very well for Vice President Barkley to speak scornfully, as he did at a dinner of Democratic Party leaders in New York last month, of those who fear the consequences of the growing size and costliness of government. But how does this belittling of the dangers of big spending — with its inevitable sequence of big taxing — reconcile with the apprehensions of Senator O'Mahoney that dearth of venture capital is threatening the very existence of the private capitalistic system? Would the Vice President include the Senator — one of the Democratic stalwarts in Congress — among the jittery prophets of "statism" who, as he put it in an oratorical flight, "regard every tree frog as a roaring lion and every innocent angleworm as a spreading adder?"

Despite his expressed concern over the fate of private capitalism, Senator O'Mahoney apparently sees no way of cutting government expenditures and taxes. Following the testimony before his committee of several witnesses, including insurance company executives, advocating cuts in government costs, the Senator burst out:

> I am frank to say to you that this is arrant nonsense from my point of view — the talk about cutting government expenditures unless we are willing to say "We shall not defend ourselves, we shall let the international problem catch up with us" - - -
>
> I am curious to know whether there are any insurance company executives who would tell us whether we should cut down on the $6,000,000,000 appropriation for veterans. What life insurance executive is going to tell us where to cut and how? When you come to the committee and recommend that the budget be balanced by cutting expenses or increasing taxes, you've got to tell us how.

Now it so happens that on the self-same day that Senator O'Mahoney gave voice to these sentiments, Senator Byrd, of Virginia, chairman of the Joint Committee on Reduction of Nonessential Federal Expenditures, made public a report spelling out function by function how the 1950-

51 budget could be balanced and made to yield a surplus – not by increasing taxes but by lopping off some $7 billion of expenses from the President's latest budget estimate of $43 billion for the current fiscal year. A few days ago another leading Democratic Senator, Paul H. Douglas of Illinois, outlined nine specific ways of cutting expenditures totaling $4½ billion. And there have been other careful studies, including the Hoover Report, showing how expenses could be reduced if Senator O'Mahoney seriously wants to know.

As for the old alibi as to the untouchability of expenditures for defense, veterans, etc., the statement by Secretary of Defense Johnson that he had put into effect economies that would cut military expenditures by $1.5 billion this fiscal year without sacrifice of military efficiency demonstrates what can be done when there is the will to do it.

The trouble is, as Representative Walter Judd, of Minnesota, recently observed about budget-cutting, "Where there is no will, there is no way." Unquestionably, both expenditures and taxes can be cut if the people can be made aware of the dangers of the spending spree upon which they are embarked.

Other Barriers to Risk Investment

Taxes of course are not the only barrier to finding risk capital. There are many others. They range all the way from uncertainty over the international situation and fear of war, to doubts as to the soundness of the domestic situation and as to how long the present good business earnings can be expected to last.

On the home front, the little business man finds the going increasingly tough in the face of increased competition, the jacking up of minimum wage laws, the increasingly burdensome paper work involved in making out multitudinous government reports, collecting taxes, etc., strikes and restrictive practices by labor, and bickering with labor union leaders over questions frequently trivial, but often involving fundamental management issues. At the same time, big business finds itself under constant attack.

Finally, underlying everything else is a deep-seated distrust among business men and investors of the socialistic trend of government and the growing monopoly power of the great labor unions – the latter manifested by the situation in the coal industry, and by the summary manner in which the vastly complicated question of industrial pensions was dealt with under pressure of a paralyzing strike in the steel industry. The extent to which this latter question is loaded with dynamite was indicated by Harry A. McDonald, chairman of the Securities and Exchange Commission, in an address before the annual convention of the Investment Bankers Association in Florida last month. Pointing out that pension agreements won by organized labor represent additional claims coming ahead of shareholders' equity, Mr. McDonald warned that –

> Were corporations today who have signed a pension contract with a labor union to show their true and immediate past service liability without considering the continuing entity of the corporation, it could easily wipe out their entire surplus.

Is it any wonder, in view of the tax barrier and discouragements, that capital for risk enterprise has not been plentiful in the investment markets?

Credit Policy and Economic Stability

Since the end of the war the United States has been faced with a basic question in monetary policy. Can we have credit cheaply available at all times and under all circumstances, and still have sound money and a stable economy? The issue has been raised by continuing use of Federal Reserve open market operations to peg prices of government securities. During the past month it has been brought into sharp focus by a joint Congressional investigation, originating in the Congressional Joint Committee on the Economic Report. For the first time monetary policy has been publicly reviewed, with exhaustive testimony particularly from the officials concerned.

Last March this committee announced its plan to appoint a subcommittee to pursue an investigation of "monetary policy," the "machinery for monetary policy formation and execution," and "the problem of coordinating monetary, credit, and fiscal policies with general economic policy." Under authority of a Concurrent Resolution, approved in May, a subcommittee was appointed in early July consisting of Senator Paul H. Douglas of Illinois, chairman; Senator Ralph E. Flanders of Vermont; Congressman Frank Buchanan of Pennsylvania; Congressman Wright Patman of Texas; and Congressman Jesse P. Wolcott of Michigan. Professor Lester V. Chandler of Amherst College assisted the subcommittee as economist. The study was conducted in a spirit of impartial inquiry, and, while the final report is not yet available, the documents published by the subcommittee and its hearings have already aroused public attention to a deep-seated conflict in our fiscal and monetary policy.

The subcommittee began its work by sending out questionnaires to responsible officials of Government and of government agencies, as well as

to bankers, economists, state banking commissioners, and officials of trade associations, insurance companies, labor and farm organizations, industrial corporations, etc. The response to the questionnaires addressed to Government and Federal Reserve officials was complete and their answers to the questions, well designed to crystallize basic issues, comprise a principal fruit of the inquiry. A small response from economists, bankers and others to whom questionnaires were sent was probably explainable by the formidable array of questions.

The issue that emerged as the hearings progressed was the difficulty of harmonizing the Federal Reserve System's responsibility of maintaining economic stability with the objective of maintaining stable markets for government securities. Testimony made it clear that there had been over the past few years decided conflicts of opinion from time to time among Federal Reserve and Treasury officials as to the level of interest rates and the policy of supporting the government security market.

Interest Rates and Inflationary Pressures

A majority of the Federal Reserve Bank presidents gave an affirmative answer when the question was put to them: "Would a monetary and debt management policy which would have produced higher interest rates during the period from January 1946 to late 1948 have lessened inflationary pressures?" They explained in a joint answer how this would have worked:

> A more restrictive monetary and debt-management policy in the postwar period would have included higher rates on short-term Government securities, higher yields on Government bonds (with some prices probably below par), and lessened purchases of Government securities in the open market on behalf of the Federal Open Market Committee. The supply of reserve funds available to commercial banks as the basis for loan expansion would have been reduced. Life-insurance companies and other institutional investors would have had to accept capital losses in attempting to sell Government securities, and this might have discouraged transfer of some of their investments into corporate bonds, State and local government obligations, and mortgages.

The answers by the Federal Reserve presidents are in many respects of particular value, not only because five of them join with the Federal Reserve Board in composing the Federal Open Market Committee, which controls Federal Reserve Bank purchases and sales of government securities, but also because they have a close "feel of the market" drawn from day-to-day experience.

Why Not More Effective Action?

Why was a more restrictive policy not followed? The answers to the subcommittee's questionnaires bring out the story. No one wanted to do too much of a job of credit restriction, and possibly precipitate a general deflation. A theory held sway that disaster would ensue if government bond prices declined ever so slightly below par. Thus in 1947 the Federal Open Market Committee entered into an agreement with the Treasury to peg long-term government bonds at par or safely above. Taking away wartime pegs for short-term Treasury bills and certificates, which the Federal Open Market Committee wanted to do, was delayed and slowed by Treasury objections. The Treasury throughout was concerned to hold down the interest cost of the public debt.

Allan Sproul, president of the New York Federal Reserve Bank, in testimony on December 2, commented that the record of cooperation between the Treasury and Federal Reserve "has been better than might have been expected, and so has the record of our economy, whatever connection there may be between the two."

> But [he went on to say] agreed action, in my opinion, has most often been too little and too late, so far as the aims of an effective monetary program were concerned. For example, the System wanted to discontinue its preferential discount rate on Government securities maturing within one year, before the end of 1945; Treasury acquiescence, and the action, did not come until April 1946.
>
> From the closing months of 1945 through all of 1946, the System was pressing for discontinuance of its artificially low buying rate – ⅜ of 1% – on Treasury bills; the action finally came, with Treasury agreement, in July 1947.
>
> From that point on, as inflationary pressures increased, the System wished to follow a program of credit restraint which would have necessitated small but, perhaps, frequent increases in short term interest rates which would have meant similar increases in rates on Treasury bills and certificates, and some increase in the yield of other short and intermediate Government securities.
>
> The Treasury did a large part of the job, of course, by devoting its substantial cash surpluses to the retirement of debt in such a manner as greatly to aid in achieving the common objective; but the Treasury was generally several months behind in accepting the implications of a tightening policy for the interest rates on its short term securities.

Reserve Requirements

Thomas B. McCabe, chairman of the Federal Reserve Board, revealed in testimony the following day that there had been "widely varying shades of judgment" within the Federal Reserve System on the par pegging of long-term government bonds and stated that the reluctance of the Treasury to pay higher rates on short-term bills and certificates "reinforced the disposition" of the Board of Governors to raise bank reserve requirements.

Chairman McCabe expressed his personal belief that the 1948 increase in reserve require-

ments had some effect in restricting credit because they "diminished the liquidity" of the member banks. "In retrospect, however," he stated, "I would also say that my reluctance to resort to changes in reserve requirements as a method of dealing with an inflationary situation has been increased, not diminished, by the experience."

Mr. Sproul, in answer to the questionnaire, suggested that

> . . . changes in reserve requirements should be made only to meet fundamental changes in the reserve position of the banks, or to accomplish a major structural adjustment in the expansion potential of our fractional reserve banking system. I would not endorse the use of changes in reserve requirements to carry out short-term shifts in policy. Constant jiggling of reserve requirements is not the way to run a banking system. Open-market and discount operations are much better suited, as I see it, to the sensitive adjustments called for in effecting ordinary variations in bank reserve positions, and thus influencing the cost and availability of credit.

Ray M. Gidney, president of the Cleveland Reserve Bank, stated that "the authority to alter member-bank reserve requirements is a clumsy and unsatisfactory instrument of credit control" which, affecting all banks, "may have unhealthy general effects and be harmful in many individual instances." He suggested that:

> Bankers generally would appreciate our giving the matter a rest cure and letting them feel that they have a stable basis of reserves on which to operate.

The subcommittee's questions on reserve requirements evoked an extreme range of ideas which space limitations forbid covering in these pages. A number of respondents considered reserve requirement changes with rigidly pegged markets for government securities more or less an exercise in futility. Economists were often favorably disposed to grants of enlarged powers to alter bank reserve requirements but were virtually unanimous in condemning pegged markets. Postwar Federal Reserve policy — taken as a whole — found meager approval among the economists.

In answer to the question, "What attention should the Federal Reserve give to interest charges on the government debt and to the prices of government securities," Professor Howard S. Ellis of the University of California, President of the American Economic Association, gave forceful expression to some feelings quite evidently shared by many respondents outside the official circle:

> In a war, the Federal Reserve has categorically an obligation to support the Government bond market. In peacetimes, by and large, the prices of Governments should be determined by free market forces, since the holdings of small individual savers are chiefly in the form of redeemable issues. In the postwar period, the Federal Reserve System has been hamstrung in the exercise of central banking functions by its categoric acceptance of the support of the Government (or Treasury) pattern of interest rates, as its first obligation.

Questions on the adequacy of Federal Reserve powers raised by the subcommittee elicited from Federal Reserve officials a number of suggestions for additional powers or improvements in the organization of the Federal Reserve System. But while improvements in organization are always in order, talk of the needs for "new powers" seemed rather beside the point in light of the extremely cautious use that has been made of admittedly potent weapons already in hand, notably the power to suck up lendable funds by Federal Reserve sales of government securities in the open market.

What Is the Reserve System For?

It is a good time to review the question, what is the Federal Reserve System for? To whom is it responsible? What should be the guides to monetary and credit policy and who should decide those policies?

Quite appropriately, the subcommittee's questionnaires raised these very questions. The Reserve Board governors and the Federal Reserve Bank presidents were asked to say what they thought were "the more important purposes and functions" that the Federal Reserve should perform. The Federal Reserve Bank presidents, in a joint answer to this question, stated:

> The basic continuing objective of Federal Reserve policy has been to promote economic stability at high levels of employment and production. This general objective underlies the wide variety of phrases that have been used in the past four decades to describe the System's purposes in general and enumerate them in detail.
>
> Agreement on this basic objective is clear, for example, in the following statements, even though the first was made in 1913 by the chairman of the Senate Committee on Banking and Currency and the second in 1946 by the Board of Governors:
>
> > Senate bill No. 2639 is intended to establish an auxiliary system of banking, upon principles well understood and approved by the banking community, in its broad essentials, and which, it is confidently believed, will tend *to stabilize commerce and finance*, to prevent future panics, and place the Nation upon an era of *enduring prosperity*. [Statement of Robert L. Owen, chairman of the Senate Committee on Banking and Currency, 1913.]
> >
> > It is the Board's belief that the implicit, predominant purpose of Federal Reserve policy is to contribute, insofar as the limitations of monetary and credit policy permit, to an economic environment favorable to the *highest possible degree of sustained production and employment*. [Annual Report of the Board of Governors of the Federal Reserve System for 1946.]

(The "strategic words" were italicized in the reply.)

Chairman McCabe's answer ran along similar lines and referred to the same statement from the Reserve Board's Annual Report for 1946, and the same statement by Robert L. Owen who was Chairman of the Senate Banking and Currency Committee in 1913 when the Federal Reserve legislation was under discussion.

In the statements of their "more important purposes and functions" neither Chairman McCabe nor any of the Reserve Bank presidents mentioned what has actually been the overriding objective in the war and postwar years — namely "to exert its influence toward maintaining conditions in the United States Government security market that are satisfactory from the standpoint of the Government's requirements."* This leads to the question, to whom is the Federal Reserve responsible?

To Whom Is the Federal Reserve Responsible?

No clearcut answer to this question emerged in the subcommittee's documents. By law, the Federal Reserve System is an independent agency, established by Congress and for the purposes, as written in the Federal Reserve Act:

> To provide for the establishment of Federal reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes.

It would seem proper to say that the Federal Reserve's paramount responsibility is to the people and to their elected representatives in the Congress rather than to any particular elected or appointed officer of government. The seven members of the Federal Reserve Board are appointed, with the approval of the Senate, by the President of the United States who also names the chairman, but the terms are long — fourteen years — and are staggered to protect the Board from being made or becoming a simple tool of politics. Moreover, the system was given, in the Jeffersonian spirit of decentralization, a broad base of representation — on the boards of directors of the twelve Federal Reserve Banks and on the Federal Advisory Council — of responsible and informed men from many walks of life and all parts of the country. This is the structure and the strength of the Federal Reserve System.

Governor Eccles' Protest

Governor Eccles of the Federal Reserve Board, in a letter filed with the Douglas subcommittee December 2, reviewed the unusual manpower resources of the Reserve System and was led to comment:

"Under present circumstances the talents and efforts of these men are largely wasted." He protested that: "In making a cheap money market for the Treasury, we cannot avoid making it for everybody. All monetary and credit restraints are gone under such conditions; the Federal Reserve becomes simply an engine of inflation."

Governor Eccles' letter was precipitated by the Treasury's decision, announced December 1, to keep unchanged what Governor Eccles described as a "very low rate pattern during a period of credit expansion." The Federal Reserve authorities, evidently, were disposed to lower their support levels for short-term government securities, which would have required the Treasury to pay a little more interest on its note and certificate offerings scheduled for December 15 and January 1, or otherwise to adjust to firmer money conditions. The Treasury instead determined on a four-and-a-quarter-year term for notes paying only 1⅜ per cent and on a continuation of a 1⅛ per cent rate on one-year certificates. The Treasury announcement of terms put the Federal Reserve authorities under what they considered to be a moral obligation to see these refundings through. Thus they were estopped from applying even a mild restraint on the credit supply at least until after the January 1 certificates had been successfully refunded.

June Policy Statement

Senator Douglas appropriately asked Chairman McCabe to explain this episode in light of the public statement of the Federal Open Market Committee, last June 28, that "it will be the policy of the Committee to direct purchases, sales, and exchanges of Government securities by the Federal Reserve Banks with primary regard to the general business and credit situation." Mr. McCabe's testimony gave the first satisfactory official interpretation of that statement which he characterized as "a significant milestone":

> I regard the announcement as a significant milestone because it reflected the joint judgment of the Treasury and of the Federal Open Market Committee that the postwar economic and financial situation had evolved to a point where open market operations could safely be permitted to play a more orthodox role in our policies. Such operations will, of course, continue to be affected by concern for the stability of the Federal debt and its repercussions upon the entire debt structure. The public debt is now a dominant part of the financial structure. No one informed on money market operations expects that open market policies will ignore this fact. The public debt, however, huge as it still is, has become

*Quoted from December 8, 1941 statement by Federal Reserve Board.

sufficiently settled in the hands of stable holders to permit open market policy to be formulated on a more flexible basis than formerly. I regard June 28, 1949, as a most important date. It signified removal of the "strait jacket" in which monetary policy had been operating for nearly a decade, that is, since the beginning of the war.

Under questioning by Senator Douglas, Chairman McCabe explained that it was the understanding of the Treasury that the latter set rates on refundings and that "we so recognize it." At the same time he expressed satisfaction with the "splendid cooperation" existing between the Treasury and the Federal Reserve. The implication of Senator Douglas' questioning seemed to be that the "cooperation" has been achieved by rather too many concessions to the Treasury viewpoint.

Treasury Secretary Snyder, in the hearings, had no public comment on this issue. In answer to the questionnaire Secretary Snyder pointed out that the second World War had been financed at an average borrowing cost less than half that of World War I, described how surplus revenues in 1947 and 1948 had been used to pay down the debt and at the same time curb inflationary pressures, emphasized the "considerable magnitude" of debt refunding operations – operations which run to $50 billion a year – and stressed the importance of maintaining a broad ownership of the public debt and confidence in the credit of the Government.

In his testimony Secretary Snyder gave his view that bankers have a right to expect that the debt will be properly managed, but denied that the Federal Government is under any direct or implied obligation to support the market. "Our obligation is to pay them off at maturity."

A Congressional Directive?

The problem, as summed up by Mr. Allan Sproul, president of the New York Federal Reserve Bank and vice chairman of the Federal Open Market Committee, is "how to combine effective monetary management with effective debt management." Commenting on the problem in testimony before the Congressional subcommittee on December 2 Mr. Sproul said:

There cannot be a purposeful monetary policy unless the Federal Reserve System is able to pursue alternating programs of restraint, "neutrality," and ease, in a roughly contra-cyclical pattern. Such programs must, as they accomplish an increase or contraction in the volume of credit and a tightening or loosening in the availability of credit, affect interest rates, not only for private credit, but for Government securities. The terms of Treasury offerings for new money, and for refunding issues, must be affected. Yet those effects will, at times, be inconvenient and burdensome to the Treasury in its management of the enormous public debt, and may conflict with otherwise praiseworthy efforts to minimize expenditures for debt service.

This is an inherent conflict. It will continue to arise, in one form after another, so long as this public debt, huge in relation to our present national income, is with us. It is important, therefore, that better means be found, if possible, for reconciling potential differences between the Treasury and the Federal Reserve System so that action in the credit sphere may be taken promptly, as needed, in reasonable harmony with the action being taken by the Treasury in the sphere of debt management.

Pointing to the Treasury deficit as giving an "inevitable bias toward inflationary pressure, when the economy is already working close to capacity," Mr. Sproul went on to suggest:

It is this situation which lends weight to the suggestion that there be a Congressional directive, specifying as part of the legislative framework for debt management that the Treasury should work within the structure of interest rates appropriate to the economic situation. The implication of such a directive would be that the Treasury could not, as a matter of right or of superior position, call upon the Federal Reserve System to "make a market for its securities" at rates which the System believed to be out of line with the degree of credit restraint considered necessary by the System.

I recognize that there would continue to be differences of opinion about these matters, and I realize that you cannot legislate cooperation between people, but the Congress, as final arbiter, might be able to provide a mandate which would charge debt management as well as monetary management with some responsibility for the objectives specified in the Employment Act of 1946.

The country cannot afford to keep money cheap at all times and in all circumstances, if the counterpart of that action is inflation, rising prices, and a steady deterioration in the purchasing power of the dollar – including the purchasing power of the dollars which the Government itself must spend and the purchasing power of dollars invested by the public in Government securities.

The issue is whether the objective of policy should be a stable economy or stable government security prices. We cannot have both, in all circumstances.

THE NATIONAL CITY BANK OF NEW YORK

Condensed Statements of Condition

THE NATIONAL CITY BANK OF NEW YORK

***Head Office:* 55 Wall Street, New York**

Including Domestic and Overseas Branches

ASSETS

	Dec. 31, 1949	*Dec. 31, 1948*
Cash, Gold and Due from Banks	$1,264,319,879.82	$1,532,119,431.07
United States Government Obligations *(Direct or Fully Guaranteed)*	1,902,584,206.34	1,656,863,022.03
Obligations of Other Federal Agencies	33,038,024.76	20,800,544.06
State and Municipal Securities	315,078,022.72	223,270,860.19
Other Securities	90,859,706.67	80,736,634.65
Loans and Discounts	1,381,156,839.97	1,422,290,651.94
Real Estate Loans and Securities	560,010.80	2,693,232.40
Customers' Liability for Acceptances	19,194,542.41	22,194,546.28
Stock in Federal Reserve Bank	7,500,000.00	7,500,000.00
Ownership of International Banking Corporation	7,000,000.00	7,000,000.00
Bank Premises	27,021,457.69	27,686,864.86
Other Assets	3,675,648.04	1,581,830.85
Total	$5,051,988,339.22	$5,004,737,618.33

LIABILITIES

Deposits	$4,669,251,863.23	$4,643,112,363.66
Liability on Acceptances and Bills *(Own Acceptances in Portfolio Deducted 1949—$6,559,133.54; 1948—$8,562,589.49)*	22,960,968.52	26,031,806.46
Items in Transit with Branches	13,472,380.16	12,647,857.33
Due to Foreign Central Banks *(In Foreign Currencies)*	9,527,700.00	—0—
Reserves for:		
Unearned Discount and Other Unearned Income	8,053,790.40	5,925,327.28
Interest, Taxes, Other Accrued Expenses, etc.	25,778,521.17	21,006,274.30
Dividend	2,480,000.00	4,650,000.00
Capital *(6,200,000 Shares 1949—Par $20; 1948—Par $12.50)*	124,000,000.00	77,500,000.00
Surplus	126,000,000.00	172,500,000.00
Undivided Profits	50,463,115.74	41,363,989.30
Total	$5,051,988,339.22	$5,004,737,618.33

Figures of Overseas Branches are as of December 23.

For 1949, $303,564,822.00 ($272,043,209.00 in 1948) of United States Government Obligations and $7,665,500.00 ($643,355.26 in 1948) of other assets are deposited to secure $220,807,890.56 ($199,885,738.82 in 1948) of Public and Trust Deposits and for other purposes required or permitted by law.

(MEMBER FEDERAL DEPOSIT INSURANCE CORPORATION)

CITY BANK FARMERS TRUST COMPANY

***Head Office:* 22 William Street, New York**

ASSETS

	Dec. 31, 1949	*Dec. 31, 1948*
Cash and Due from Banks	$ 43,740,244.24	$ 24,260,705.47
United States Government Obligations *(Direct or Fully Guaranteed)*	84,171,023.36	81,048,715.79
Obligations of Other Federal Agencies	1,550,957.62	1,048,351.88
State and Municipal Securities	7,473,628.09	5,591,935.26
Other Securities	101,037.50	101,037.50
Loans and Advances	1,107,448.50	794,038.43
Real Estate Loans and Securities	1,105,978.45	2,014,994.22
Stock in Federal Reserve Bank	600,000.00	600,000.00
Bank Premises	2,923,162.32	3,027,312.81
Other Assets	2,453,447.77	2,693,779.70
Total	$145,226,927.85	$121,180,871.06

LIABILITIES

Deposits	$111,945,613.33	$ 88,162,629.38
Reserves *(Includes Reserve for Dividend 1949—$310,590.14; 1948—$310,652.47)*	3,248,071.46	3,587,040.80
Capital	10,000,000.00	10,000,000.00
Surplus	10,000,000.00	10,000,000.00
Undivided Profits	10,033,243.06	9,431,200.88
Total	$145,226,927.85	$121,180,871.06

For 1949, $7,802,828.70 ($3,654,387.56 in 1948) of United States Government Obligations are deposited to secure $1,604,831.93 ($1,135,778.77 in 1948) of Public Deposits and for other purposes required or permitted by law.

(MEMBER FEDERAL DEPOSIT INSURANCE CORPORATION)

DIRECTORS

WM. GAGE BRADY, JR.
Chairman of the Board
W. RANDOLPH BURGESS
Chairman of the Executive Committee
HOWARD C. SHEPERD
President

SOSTHENES BEHN
Chairman, International Telephone and Telegraph Corporation
CURTIS E. CALDER
Chairman of the Board, Electric Bond and Share Company
GUY CARY
Shearman & Sterling & Wright
EDWARD A. DEEDS
Chairman of the Board, The National Cash Register Company
CLEVELAND E. DODGE
Vice-President, Phelps Dodge Corporation
L. M. GIANNINI
President, Bank of America National Trust and Savings Association
JOSEPH P. GRACE, JR.
President, W. R. Grace & Co.
WILLIAM H. HOOVER
President, Anaconda Copper Mining Company
AMORY HOUGHTON
Chairman of the Board, Corning Glass Works
ROGER MILLIKEN
President, Deering, Milliken & Co. Incorporated
FREDERICK B. RENTSCHLER
Chairman, United Aircraft Corporation
GERARD SWOPE
Honorary President, General Electric Company
REGINALD B. TAYLOR
Williamsville, New York
ROBERT WINTHROP
Robert Winthrop & Co.

DIRECTORS

W. RANDOLPH BURGESS
Chairman of the Board
LINDSAY BRADFORD
President

WM. GAGE BRADY, JR.
Chairman of the Board, The National City Bank of New York
GILBERT G. BROWNE
22 William Street
J. HERBERT CASE
22 William Street
EDWARD C. DELAFIELD
Delafield & Delafield
CLEVELAND E. DODGE
Vice-President, Phelps Dodge Corporation
ROBERT W. DOWLING
President, City Investing Company
SAMUEL SLOAN DURYEE
Spence, Hotchkiss, Parker & Duryee
L. M. GIANNINI
President, Bank of America National Trust and Savings Association
ROBERT L. HOUGUET
Amend & Amend
CHARLES C. PARLIN
Shearman & Sterling & Wright
RICHARD S. PERKINS
Harris, Upham & Co.
HENRY C. TAYLOR
Taylor, Pinkham & Co., Inc.
REGINALD B. TAYLOR
Williamsville, New York
EARLE S. THOMPSON
President, The West Penn Electric Company
ROBERT WINTHROP
Robert Winthrop & Co.
WALTER REID WOLF
Senior Vice-President
BOYKIN C. WRIGHT
Shearman & Sterling & Wright